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Retirees, It's Time to Give Yourself a Raise. How to Keep the Cash Flowing for Decades.

A 5% withdrawal rate now looks "safe" for retirement savings. Using buckets for cash, income, and growth can keep it all afloat.

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It's time to throw out the 4% rule and give your retirement paycheck a raise. New research indicates that a 5% withdrawal rate is "safe"—although how you invest and tap your portfolio is critical to keep the cash flowing.

Investors have been conditioned for decades to believe they can withdraw only 4% a year through a theoretical 30-year retirement, adjusted for inflation. If you had a $1 million portfolio, for instance, you could take out $40,000 in the first year and $40,800 in the second year, assuming a 2% inflation rate. The idea is safety first, even if markets soar, to give your portfolio a high chance of lasting at least 30 years.

But several studies and retirement experts now view 4% as too conservative and inflexible. J.P. Morgan, in a recent report, recommended about 5%. David Blanchett, who has studied withdrawal rates for years, pegs 5% as a safe rate for "moderate spending" through a 30-year retirement. "It's a much better starting place, given today's economic reality and people's flexibility," says Blanchett, head of retirement research for PGIM DC Solutions.

The inventor of the 4% rule is hiking his "safe" rate too. Retired financial planner Bill Bengen tells *Barron's* he is revising his benchmark in an upcoming book, and that a rate "very close to 5%" may be warranted.

How much you can take out depends on your circumstances, of course, including plans for leaving an inheritance. Assuming you have a cushion to withstand market downturns, there's a strong case for taking out more in a bull market that has plumped up your portfolio.

Whether 5% is "safe" hinges partly on the outlook for stocks and bonds, the bedrocks of most portfolios. J.P. Morgan expects U.S.

stocks to return 8% over the next 20 years and bonds to return 5%. Those figures are in line with historic averages and assume normal market conditions for the next two decades. PGIM Quantitative Solutions expects similar returns over a 10-year horizon.

A dour forecast could mean taking out less each year. And today's starting point isn't promising by some measures. The cyclically adjusted price-to-earnings, or CAPE, ratio of the U.S. stock market is about 32% above Vanguard's estimate of its fair value, the firm wrote in a note in late August.

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When stocks are this expensive, prospects for returns diminish. For bonds, a good yardstick of expected returns is their current yield; the 30-year Treasury is now 4.1%, implying that it may be a stretch to hit 5%.

Yet exact numbers for withdrawal rates matter less than having a plan in the first place. More than half of retirees (53%) say they wing it, withdrawing money whenever they need it, according to a recent survey by investment firm Schroders.

Without a plan, it's hard to determine if your spending is sustainable. "It's extremely important to have a strategy," says Eric Trousil, an advisor at Johnson Financial Group in Green Bay, Wis.

Your mix of stocks and bonds may vary. A typical "balanced" portfolio is 60% stocks and 40% bonds. Bengen used a 50/50 split for the 4% rule and found that closer to 5% could be achieved with a 55% stock allocation that is slightly overweight U.S. small- and microcap stocks. J.P. Morgan used a more conservative 30% stock and 70% bonds to

arrive at its “optimal” withdrawal rates of 5.6% for men and 5.3% for women (since women have longer life expectancies than men).

If you’re unsure about the right mix, consider hiring an advisor who can put your investments in the context of your broader financial life and manage your portfolio.

Building Your Bucket List

If you’re going it alone, consider putting your portfolio into buckets, a strategy popularized by Morningstar and credited to financial planner Harold Evensky. The approach can accommodate withdrawal rates like 4% or 5%, and it’s useful to tailor your portfolio to your specific spending and long-term growth needs.

The idea is to divide your portfolio into three buckets: one holding cash for near-term expenses, a second in fixed income and high-yielding equities to handle intermediate expenses, and a third in growth stocks to help your portfolio beat inflation and possibly keep growing.

Your cash bucket is like your Fort Knox—it’s solid, no matter what the market does. Sitting on cash isn’t bad now, with yields of 4% to 5%, but this is an all-weather strategy to employ even after yields fall. You don’t want to be left vulnerable in a year like 2022, when both stocks and bonds fell by more than 10%. If that happens again and you don’t have a cash cushion, you’d be forced to withdraw money from a declining portfolio to pay the bills, locking in your losses and hastening the depletion of your savings.

Your cash bucket should hold enough money to *help* cover up to two years of expenses: budget items like housing, food, and transportation. It might hold vehicles like FDIC-insured certificates of deposit, high-yield savings accounts, and money market mutual funds from companies like Vanguard, Charles Schwab, and Fidelity.

This bucket doesn't hold one to two years of your overall expenses—just what you need from your portfolio. Add up your annual spending and then subtract the amount you'll receive from Social Security and other income, such as rental properties or a pension. Factor in taxes. Whatever is left over would come from the cash bucket.

Most brokerage firms allow investors to choose where they receive distributions like dividends, capital gains, or bond income. You can have yours deposited into your cash bucket to keep replenishing it. Just make sure your dividends and other distributions aren't automatically reinvested.

Once your cash needs are set, move on to the second bucket. This should hold five to eight years' worth of your required portfolio income. It should hold things like high-quality bonds and stocks that pay relatively high yields, such as utilities; real estate investment trusts, or REITs; and midstream energy companies.

Bonds are at a pivot point, with the Federal Reserve expected to start an interest-rate cutting cycle in September. The yield curve, measuring the difference between short- and long-term rates, looks close to un-inverting, finally pushing up the long end over the short. That poses reinvestment risk for bonds maturing in a year or two; when they come due, market yields could be much lower.

One way to avoid that fate is by owning intermediate-term bonds, locking in today's yields for, say, the next five to seven years. Yields may go down as rates fall, but the bonds would rise in price, resulting in similar or higher total returns.

The iShares iBonds Dec 2030 Term Corporate exchange-traded fund holds about 500 corporate bonds maturing in 2030. It yields 4.6%. Vanguard Total Bond Market ETF has a similar maturity and slightly lower yield; it covers the market more broadly, with about two-thirds of its portfolio in Treasuries and other government bonds, and the rest in corporate issues.

Since we're thinking of this bucket for income, we would suggest diversifying into high-yielding sectors like utilities, REITs, and energy pipelines. Among ETFs, consider iShares Select Dividend, which is loaded with utilities, financials, telecom, and other high-yielding sectors. For more-targeted exposure, options include Utilities Select Sector SPDR fund, Vanguard Real Estate ETF, and First Trust North American Energy Infrastructure fund.

Keep in mind that there's a tradeoff between income and growth: High-yielding stocks often trail market returns and fall far behind

those that yield less but have stronger growth prospects. Apple yields 0.5%, for instance, but the stock will live or die by the next iPhone upgrade cycle.

Which brings us to the third bucket: growth. This should hold assets to keep your portfolio growing while you deplete the cash and income. It's also the riskiest bucket and should only include money you don't expect to need for at least eight years.

The SPDR S&P 500 ETF, covering the U.S. market, has turned into a growth fund with a heavy weighting in companies like Nvidia and Microsoft. Small-caps could also go in this bucket with a fund like iShares Core S&P Small-Cap ETF. For foreign stocks, Fidelity Total International Index fund offers broad exposure to both developed and emerging markets.

Managing Your Buckets

As you spend down the cash bucket, proceeds from the third bucket can help replenish it, alongside distributions from the second bucket. A good time to top off the cash is during a strong market, when you have gains in your stock portfolio. You can sell appreciated stock and dump the proceeds into the cash bucket.

Consider running a stress test, too, says Christine Benz, director of personal finance and retirement planning for Morningstar. Say you need $30,000 a year from a $1 million portfolio. That would be just 3% and would be considered a very conservative withdrawal rate. If you discover that withdrawals would represent 10% of your portfolio, you'd have to make adjustments, such as spending less or finding other sources of income, like a part-time job.

Figuring out a safe withdrawal rate can also influence how you allocate the portfolio. Say you pick a 5% rate and decide on holding two years' worth of necessary withdrawals in the first bucket. That

would mean keeping 10% of your portfolio in cash. If the second bucket holds up to eight years' worth of withdrawals, it would hold 40% of your portfolio with the remaining 50% in the long-term growth bucket.

The bucket method relies on good estimates of your spending. If you don't have a strong sense of what you'll need—or are just planning—you could start with a withdrawal rate to calculate what you can safely take out.

"Some know exactly what they need on a monthly or annual basis, and others are looking to learn what is sustainable," says Lauren Rich, an advisor at Linscomb Wealth in Houston. "If the spending need isn't well defined, they can back into what a sustainable portfolio draw is."

Keep in mind that, once you reach 73, the Internal Revenue Service has its own ideas about how much you must withdraw from tax-deferred accounts. That's when required minimum distributions kick in, forcing you to withdraw a certain amount every year and pay ordinary income tax on it.

Those who spend their RMDs may prefer to take them monthly. In that case, distributions could be dumped into your cash bucket and used for living expenses. Or you could take them in a lump-sum at year end as part of a rebalancing strategy—for example, you could sell appreciated stock from the long-term bucket to satisfy the RMD.

One other key consideration is long-term care and medical bills as you age. Medicare doesn't cover routine help with activities of daily living. Families are generally on their own when it comes to paying for home health aides, assisted living facilities, or nursing care.

How much to set aside? Benz recommends $200,000—or more, if your situation allows—in a fourth, "last-stop bucket" that will ensure

there's money available if you need it. If you don't, that money could fund a bequest to an heir or charity.

Withdrawal rates of 4% or 5% shouldn't be ironclad. Even 5% may leave plenty of money in your account long after you need it. According to the J.P. Morgan's study, retirees adhering to 5%-plus will die with the same amount that they began with at age 65, assuming normal market returns and average life expectancies.

Those who would rather deplete most of their assets should spend more aggressively, says Jay Zigmont, CEO of Childfree Wealth in Mount Juliet, Tenn. A general rule is to withdraw at least as much as your portfolio returns in the market each year.

"If you're trying to die with zero," Zigmont says, "the basic assumptions don't fit."

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